
Office of Utilities Regulation

**Jamaica Public Service Company Limited
Z-Factor Claim for Reclassification Compensation**

Determination Notice



OFFICE OF UTILITIES REGULATION

March 2, 2010

DOCUMENT TITLE AND APPROVAL PAGE

1. DOCUMENT NUMBER: Ele 2010/1: Det/1

2. DOCUMENT TITLE: Jamaica Public Service Company Limited Z-Factor Claim for Reclassification Compensation

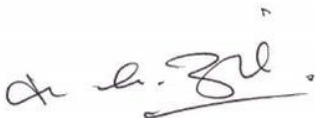
3. PURPOSE OF DOCUMENT

This document sets out the Office's decision with respect to the claim made by Jamaica Public Service Company Limited to recover the full cash flow impact arising from compensation payments it made to its workers in a job re-classification exercise.

4. APPROVAL

This Document is approved by the Office of Utilities Regulation and the Determination therein becomes effective on **March 2, 2010**.

On behalf of the Office:



Ahmad Zia Mian
Director General

Date: March 2, 2010

Abstract

In 2000 the management of JPS and the labour unions representing the workers entered into an agreement to conduct a job reclassification exercise to better align the work performed by its employees with job functions.

In this regard, Trevor Hamilton and Associates completed a review for the JPS in 2002. The results of that review sparked a dispute between the management and the unions over the level of payments that would be required. The matter was taken to the Industrial Disputes Tribunal (IDT) which issued its decision in August 2003 in favour of the workers and the unions.

JPS appealed the decision first to the Supreme Court of Jamaica and subsequently to the Court of Appeal. The IDT's decision was upheld and JPS paid out \$2.3 billion to its workers in 2008.

Against this background, JPS in 2009 submitted a claim for the full expenses associated with compensation payment on the basis of the Z-factor Clause in the ***All-Island Electricity Licence, 2001***. This document sets out the Office's determination and its underlying rationale.

Table of Contents

Abstract.....	iii
1.0 Background	1
2.0 The JPS Z-factor Claim	2
3.0 Interpretation of the Z-Factor.....	3
4.0 The OUR's Analysis of JPS' Claim.....	4
5.0 Determination.....	6

1.0 Background

The management of JPS entered into an agreement with the labour unions representing its workers in 2000 to conduct benchmarking studies aimed at ensuring better alignment of work and job functions. This objective was to be achieved through a Job reclassification exercise based on the competence of the workers. The formula for the re-alignment was to be provided by Trevor Hamilton, a human resource consultant who was engaged by the company.

The job reclassification exercise was completed in June 2002 but JPS took issue with the outcome. This was primarily due to the levels of compensation payments that were to be made.

JPS and the unions were unable to resolve the disagreement through the normal channels and so it was submitted to the Industrial Disputes Tribunal (IDT). The IDT issued its decision on August 29, 2003 in favour of the workers and the unions.

JPS then submitted an application for judicial review of the IDT's decision to the Supreme Court of Judicature of Jamaica *"on the basis that there was an error of law in the IDT judgement"*¹. The application was rejected.

The management of the company subsequently filed an appeal in the Court of Appeal. JPS's **E-News** published on April 28, 2005 states *"the Company's concern is the legal implication of the IDT ruling, since any decision on the issues in dispute will have a lasting impact on how agreements are structured and documented in the future."* The Court of Appeal in March 2007 upheld the ruling of the Supreme Court. The management of the company then proceeded to implement the reclassification exercise and in mid 2008 paid out \$2.3 billion to workers and ex-employees.

As part of its application for a rate review in 2009 the JPS submitted a claim to recover what it denotes as the cash flow impact associated with the award. The Office decided that the matters should be separated and that the application with regard to the wage claim should be treated on a stand-alone basis. The Office's analysis of JPS' request and its decisions are set out below.

¹ JPS E-News: published 27, April 2005

2.0 The JPS Z-factor Claim

JPS' previous Z-factor claims were related to damage sustained in tropical cyclones. This claim is for the full cash flow impact associated with compensation payments to its workers arising from the re-classification exercise.

The claim for \$4,272.96 million comprised three components – (i) net payment to employees, (ii) taxes paid/payable to the Government of Jamaica (GOJ) and (iii) the opportunity costs of capital (see Table below).

Table 1 Summary of Claim

Component of Claim	J\$ 000's
(i) Net Payment to Employees	2,320,656
(ii) Taxes paid/payable to GOJ	1,230,759
(iii) Opportunity Cost of Capital	721,545
Total	4,272,960

JPS contends that the claim arises from *'legitimate operating costs impacting the business in 2008-09'* and supported its position by asserting that:

1. The Performance-Based Rate-Making Mechanism (PBRM) under which it operates limits the annual adjustments in its price to the increase in inflation less targeted efficiency gains.
2. The PBRM contains a provision by way of a Z-factor clause to "mitigate the risk of undue financial distress on the Company"²
3. *"The spirit of the Z-factor clause is that it allows the utility the opportunity to recover non-routine costs due to exogenous shocks that were not contemplated under the normal rate-making process (i.e. which could not be foreseen) and which were not the direct result of mismanagement (or managerial behaviour)."*³

² See the JPS Z-Factor Adjustment Submission for 2009 (March 11, 2009) p.1

³ Ibid

On the basis of the above, JPS concludes that its claim fits within the Z-factor clause because the *“claim(s) are the result of factors that were outside of its managerial control and that to deny the recovery of such costs would be to unfairly penalise the Company especially in the context of the price cap regime”*.

The component for opportunity cost (\$721.5 million) was calculated on the basis of the following assumptions:

1. An interest rate of 11% per annum, which corresponds to JPS’ weighted average cost of debt for 2007.
2. A one-year moratorium programmed to end on June 30, 2009 on the Gross re-classification payment of \$3,551.4 million.
3. A 24-month repayment schedule by way of the application of the Z-factor clause commencing July 1, 2009.

JPS has proposed an increment to all customer bills of 6.75¢ per kilowatt-hour over a two-year period to recover the \$4,273 million claim.

3.0 Interpretation of the Z-Factor

JPS operates under a Performance-Based Rate-Making Mechanism (PBRM) which caps price on the basis of a “CPI – X” formula⁴. Under this mechanism JPS tariffs are fixed in real terms for five-year periods and as such the company is allowed annual adjustments for movements in the consumer price index (CPI) net of targeted efficiency gains (X). The formula also makes allowance for a Q-factor which reflects price adjustments for the quality of service delivered, as well as a Z-factor to account for exogenous variables.

The inclusion of the Z-factor clause in the PBRM is an explicit recognition of the fact that the company’s costs may be impacted by random factors that might cause its costs to increase independent of any decision or action on the part of the company’s management.

⁴ Referred to sometimes as “RPI-X”.

Schedule 3 of the All-Island Electricity Licence, 2001 provides as follows:

“Allowed (Z-Factor) Price Escalation Reflecting Special Circumstances”

The Z-factor is the allowed percentage increase in the price cap index due to events that:

- a) affect the Licensee’s costs;*
- b) are not due to the Licensee’s managerial decisions; and*
- c) are not captured by the other elements of the price cap mechanism.”*

4.0 The OUR’s Analysis of JPS’ Claim

The OUR has concluded that:

- I. The consequential financial liability of the reclassification exercise has impacted JPS’ costs.
- II. No provision was made for this cost in the 2004 application for the recalculation of the non-fuel base rates.
- III. The claim does not qualify under the Z-Factor provision since the costs incurred were as a consequence of managerial decisions, in that, JPS agreed with the labour unions in 2000 to embark on the reclassification exercise and must have had in its contemplation before undertaking the exercise that it would result in a likely increase in overall workers’ compensation.
- IV. JPS aggravated its costs by submitting the IDT’s ruling in favour of the workers to the Supreme Court.
- V. JPS further aggravated its costs by filing an Appeal in the Court of Appeal.
- VI. JPS’ assertion that Mirant, being oblivious to the agreement between the management and the workers for reclassification when it purchased the company in 2001, must be rejected. Any prudent due-diligence exercise that preceded the acquisition ought to have revealed this obligation. The effect of

such an obligation on the Company ought to have been captured in the purchase price paid by Mirant. The failure to include the results of such an obligation therefore rests with JPS and as such are costs which it ought to bear.

- VII. The sale of JPS to Marubeni in 2007 ought also to have taken into account the reclassification agreement as the dispute over the reclassification exercise was public knowledge at that time; in fact, at the time it was being contested in the courts. JPS' plea of ignorance as a basis for justifying its claim for compensation under the Z-factor provision must be rejected.
- VIII. JPS' contention that if: *"this matter was resolved by May 31, 2004, the increased salary costs would have been rightfully included in the normal operating costs as part of the 2004 Tariff Submission. "This would be correct and consistent with Schedule 3 paragraph (C) of the Licence which provides that the application for the recalculation of the non-fuel base rates should include in the filing "an annual non-fuel revenue requirement calculation.... . . . (t)he revenue requirement shall be based on a Test Year in which the new rates will be in effect and shall include efficient non-fuel operating costs, depreciation expenses, taxes and a fair return on investment."*

The definition of "Test Year" is set out in the Recital aforesaid. On the basis of the Licence therefore, these costs, if they were to be considered as legitimate (and this is not conceded), ought properly to have been submitted with JPS' 2004 tariff submission. To have withheld the submission to 2008 cannot be countenanced by the Office and same is hereby rejected. The IDT's decision was handed down in August 2003 and as such, sufficient time had been afforded the Company to include such salary adjustments in its 2004 Tariff Submission. JPS exercised the option instead to submit the matter to the courts for adjudication. This was a managerial decision.

- IX. JPS understands the mechanics of the PBRM which essentially decouples cost from price between review periods. Consequently, if JPS lowers its cost beyond the level projected at the beginning of the review period, it benefits from a higher rate of return. On the other hand, if costs are higher than projected, the rate of return is lower. In addition, the PBRM does not allow for

the carrying over of operating costs from one period into another because that would defeat one of the cardinal objectives of price-cap regimes – encouraging efficiency, and as such, this provides a further basis on which this claim ought to be rejected.

5.0 Determination

The Office **HEREBY DETERMINES** that the JPS' claim for the recovery of \$4,273 million under the Z-factor provision of the All-Island Electric Licence, 2001 in respect of its consequential financial liability arising from the reclassification exercise which its Management agreed with the unions representing the workers in 2000, is rejected as having no merit and being inconsistent with the criteria set forth in Schedule 3 paragraph 2 (c) and 3 (b) of the Licence respectively.